

June 23, 2023

VIA EMAIL

The Honorable Ronald D. Kouchi
Senate President
415 South Beretania Street
Hawai'i State Capitol, Room 409
Honolulu, Hawai'i 96813

VIA EMAIL

The Honorable Scott K. Saiki
Speaker, House of Representatives
415 South Beretania Street
Hawai'i State Capitol, Room 431
Honolulu, Hawai'i 96813

Re: **Financial and Program Audit of the Department of Health's Deposit Beverage Container Program, June 30, 2022, Report No. 23-07**

Dear President Kouchi and Speaker Saiki:

Please find attached Report No. 23-07, *Financial and Program Audit of the Department of Health's Deposit Beverage Container Program, June 30, 2022*, along with a copy of the Auditor's Summary. The audit was performed pursuant to Section 342G-107, Hawai'i Revised Statutes, which requires a management and financial audit of the Deposit Beverage Container Program in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005.

The report is accessible through our website at:
<https://files.hawaii.gov/auditor/Reports/2023/23-07.pdf>.

The summary is also accessible through our website at:
<https://files.hawaii.gov/auditor/Overviews/2023/23-07AuditorSummary.pdf>.

If you or other Legislators would like a printed version of the report, please let me know.

Very truly yours,

Leslie H. Kondo
State Auditor

LHK:emo

Attachments

cc/attach: Members of the Senate
Members of the House of Representatives
Carol Taniguchi, Senate Chief Clerk
Brian Takeshita, House Chief Clerk

Auditor's Summary

Financial and Program Audit of the Department of Health's Deposit Beverage Container Program, June 30, 2022

Report No. 23-07

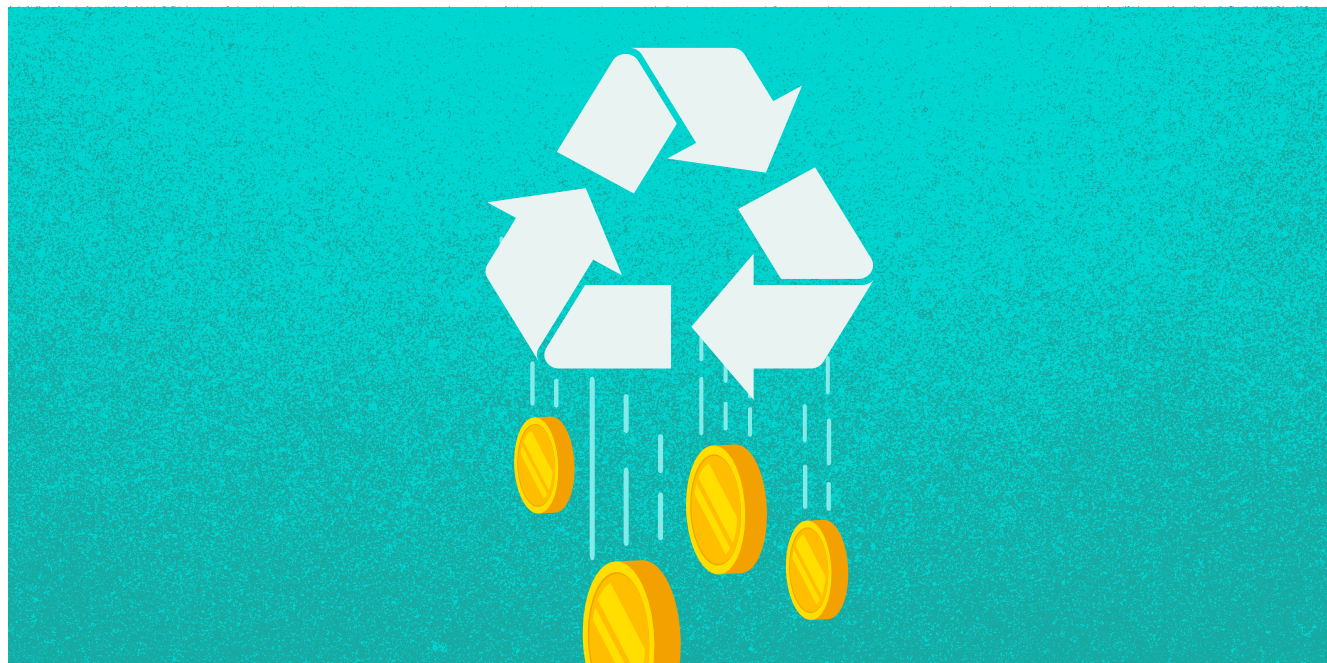


ILLUSTRATION: ISTOCK.COM

SECTION 342G-107, HAWAII REVISSED STATUTES, requires the Office of the Auditor to conduct a management and financial audit of the Department of Health's (DOH) Deposit Beverage Container Program (Program) in fiscal years ending in even-numbered years. We contracted KMH LLP, a certified public accounting firm, to conduct this financial and program audit for the fiscal year ended June 30, 2022.

Review of Prior Findings

Our previous reports to the Legislature repeatedly raised concerns that DOH's reliance on self-reported information from beverage distributors and redemption centers increases the risk of fraud, noting the parties have financial incentive to under- or over-report amounts distributors must pay into the Deposit Beverage Container Deposit Special Fund (Fund) and redemption centers may claim for reimbursement. Under the Program, distributors pay a \$0.05 container fee and \$0.01 handling fee per beverage into the Fund, generally passing those costs on to consumers. Consumers are reimbursed \$0.05 per container at redemption centers, which in turn receive payment from the Program based on the number of containers they report as redeemed.

Act 12 requires DOH "to develop a risk-based process to help remedy the flaws in the deposit beverage container program."

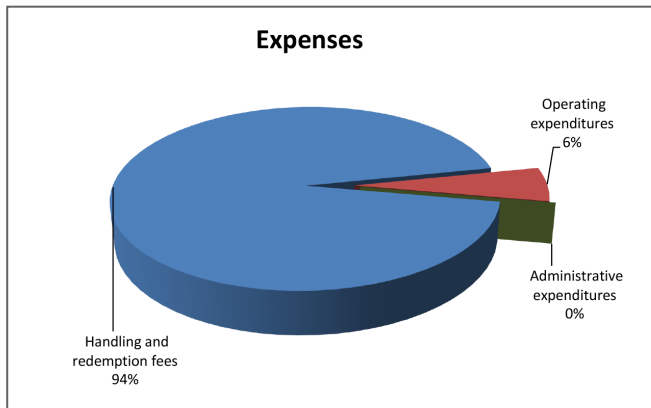
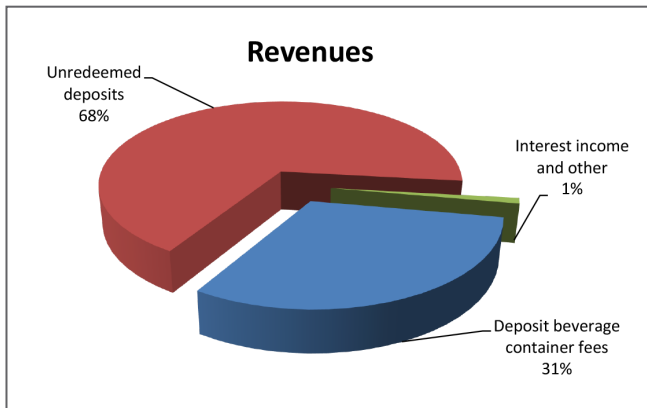
In 2022, the Legislature passed Act 12, Session Laws of Hawai'i, to compel DOH to develop and implement procedures to verify the accuracy and completeness of data reported by beverage distributors and redemption centers as recommended in the Office of the Auditor's biennial reports. Act 12 requires DOH "to develop a risk-based process to help remedy the flaws in the deposit beverage container program."

Given the relatively short period of time elapsed since the issuance of our last review in December 2021 (Report No. 21-13) and the enactment of Act 12, we believed it would be unrealistic to expect DOH to already have significant and meaningful improvements in place that we could audit. Therefore, in addition to required financial information, we asked DOH to provide us with an update on the steps it has taken to improve the Deposit Beverage Container Program (Program) and implement the 2021 audit recommendations. As part of the audit, the department submitted excerpts from various action plans and additional status updates on actions taken as of August 26, 2022.

We have not provided commentary on the Program's status or findings related to the department's action plans and status updates in this report. We appreciate that the Program has taken steps to make improvements and implement the recommendations in Report No. 21-13 and we look forward to performing a more detailed review in the future.

2023 Status Update Provided By DOH

In status updates provided on August 26, 2022, the department reported that it is actively recruiting an inspector to fill out its enforcement section, as well as filling other vacancies, anticipating that full staffing will enable the department to increase the frequency of redemption center inspections from quarterly to every other month. The department has also revised its redemption center certification application for new applicants and those renewing certification. Since September 2021, applicants have been required to provide operational plans that incorporate fraud prevention procedures to ensure the collected beverage containers are secured and that receipts given to customers correlate with the deposit containers collected. In addition, the department is seeking amendments to administrative rules that are needed, for instance, to require beverage distributors to conduct independent third-party audits to verify the accuracy of their deposits and reports to the State. The department reported plans to convene an advisory committee to assist in developing any new administrative rules related to the Program as well as help update the State Integrated Solid Waste Management Plan.



Financial Highlights

FOR THE FISCAL YEAR ended June 30, 2022, the Fund reported total revenues of \$32.97 million and total expenditures of \$27.71 million, resulting in a change in fund balance of \$5.26 million. Total revenues consisted of (1) deposit beverage container fees of \$10.21 million, (2) unredeemed deposits of \$22.52 million, and (3) interest income and other of \$245,000. Total expenditures consisted of (1) handling and redemption fees of \$26.15 million, (2) operating expenditures of \$1.54 million, and (3) administrative expenditures of \$30,000.

As of June 30, 2022, total assets were \$63.15 million and total liabilities were \$6.07 million. Total assets were comprised of (1) cash and cash equivalents of \$57.16 million, (2) accounts receivable of \$5.95 million, and (3) interest receivable of \$44,000. Total liabilities were comprised of (1) vouchers and contracts payable of \$4.06 million, (2) beverage container deposits of \$1.95 million, (3) unearned revenue of \$11,000, and (4) accrued wages and employee benefits of \$45,000.

Auditors' Opinion

The Fund received an unmodified opinion that its financial statements were presented fairly, in all material respects, in accordance with generally accepted accounting principles.

Findings

There were no reported deficiencies in internal control over financial reporting that were considered to be material weaknesses and no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, the auditors identified a significant deficiency in internal control. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. The significant deficiency is reported on page 24 of the report.



Link to the complete report:

Financial and Program Audit

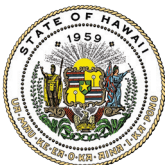
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Financial and Program Audit of the Department of Health's Deposit Beverage Container Program, June 30, 2022

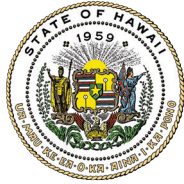
A Report to the Governor
and the Legislature of
the State of Hawai'i

Conducted by
The Auditor, State of Hawai'i
and KMH LLP

Report No. 23-07
June 2023



OFFICE OF THE AUDITOR
STATE OF HAWAII



OFFICE OF THE AUDITOR STATE OF HAWAII

Constitutional Mandate

Pursuant to Article VII, Section 10 of the Hawai'i State Constitution, the Office of the Auditor shall conduct post-audits of the transactions, accounts, programs and performance of all departments, offices and agencies of the State and its political subdivisions.

The Auditor's position was established to help eliminate waste and inefficiency in government, provide the Legislature with a check against the powers of the executive branch, and ensure that public funds are expended according to legislative intent.

Hawai'i Revised Statutes, Chapter 23, gives the Auditor broad powers to examine all books, records, files, papers and documents, and financial affairs of every agency. The Auditor also has the authority to summon people to produce records and answer questions under oath.

Our Mission

To improve government through independent and objective analyses.

We provide independent, objective, and meaningful answers to questions about government performance. Our aim is to hold agencies accountable for their policy implementation, program management and expenditure of public funds.

Our Work

We conduct performance audits (also called management or operations audits), which examine the efficiency and effectiveness of government programs or agencies, as well as financial audits, which attest to the fairness of financial statements of the State and its agencies.

Additionally, we perform procurement audits, sunrise analyses and sunset evaluations of proposed regulatory programs, analyses of proposals to mandate health insurance benefits, analyses of proposed special and revolving funds, analyses of existing special, revolving and trust funds, and special studies requested by the Legislature.

We report our findings and make recommendations to the Governor and the Legislature to help them make informed decisions.

For more information on the Office of the Auditor, visit our website:
<https://auditor.hawaii.gov>

Foreword

This is a report on the financial and program audit of the Department of Health's Deposit Beverage Container Program as of and for the fiscal year ended June 30, 2022. The audit was conducted pursuant to Section 342G-107, Hawai'i Revised Statutes, which requires the Office of the Auditor to conduct a management and financial audit of the Deposit Beverage Container Program and Deposit Beverage Container Deposit Special Fund in fiscal years ending in even-numbered years, after the initial audit for the fiscal year ended June 30, 2005. The audit was conducted by the certified public accounting firm of KMH LLP with the assistance of the Office of the Auditor.

Leslie H. Kondo
State Auditor

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PHOTO: ISTOCK.COM

Financial and Program Audit of the Department of Health’s Deposit Beverage Container Program, June 30, 2022

Introduction

T HIS IS THE NINTH BIENNIAL financial and program audit of Department of Health’s (DOH) Deposit Beverage Container Program (Program) and Deposit Beverage Container Deposit Special Fund (Special Fund). The Legislature established the Program in 2002 to increase recycling of specific types of beverage containers, reduce litter, and provide a connection between beverage container manufacturing decisions and the recycling program management.¹

Our prior reviews have repeatedly raised concerns that DOH’s reliance on self-reported information from beverage distributors and redemption centers increases the risk of fraud.

¹ Section 1, Act 176, Session Laws of Hawai‘i 2002, codified as Chapter 342G, Part VIII, Hawai‘i Revised Statutes.

The Special Fund was created to hold fees, deposits, and accrued interest – moneys that are used to pay deposit beverage container refunds and handling fees.

Our prior reviews have repeatedly raised concerns that DOH's reliance on self-reported information from beverage distributors and redemption centers increases the risk of fraud. Specifically, we have pointed out that distributors and redemption centers have financial incentive to under- or over-report the amounts that the former must pay into the Special Fund and the latter may claim for reimbursement. For example, in Report No. 15-02, we found a distributor, Whole Foods Market, Inc., had substantially underpaid the Program for more than six years – depositing \$0.06 for each case of beverages instead of \$0.06 for each individual container. The Program could not collect underpayments for the full six-year period but recovered \$46,198 for underpayments made from July 2012 through December 2014. And Report No. 19-08 identified instances of actual fraud at a redemption center. During that review, auditors compared receipts received for redeeming containers at a redemption center with the center's cash receipt log, finding the amounts they received were significantly lower than what the redemption center had claimed and DOH had reimbursed.

In 2022, the Legislature passed Act 12, Session Laws of Hawai'i, to compel DOH to develop and implement procedures to verify the accuracy and completeness of data reported by beverage distributors and redemption centers as recommended in the Office of the Auditor's biennial reports. Act 12 requires DOH "to develop a risk-based process to help remedy the flaws in the deposit beverage container program."

Given the short period of time elapsed since the issuance of our last review in December 2021 (Report No. 21-13) and the enactment of Act 12, we believe it is unrealistic to expect DOH to already have significant and meaningful improvements in place that we can audit. Instead, we asked DOH to provide us with an update on the steps it has taken to improve the Program and implement the 2021 audit recommendations. The department submitted excerpts from various action plans and additional status updates on actions taken as of August 26, 2022, which we report herein. We did not assess these efforts. We will perform a more detailed review in the future.

Background

In 2002, the Legislature established the Program through House Bill No. 1256, House Draft 2, Senate Draft 2, Committee Draft 1, which became Act 176, Session Laws of Hawai'i 2002. The act, codified in Chapter 342G, Part VIII, Hawai'i Revised Statutes (HRS), also created the Special Fund to hold the deposits and handling fees collected by distributors.

The Legislature intended the Program to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter. The nickel-redemption program created under Act 176 was aimed at recovering 80 percent of the then-estimated 800 million bottles and cans sold annually in Hawai‘i. With the passage of Act 176, Hawai‘i became one of 11 states to have some form of beverage container recycling program.

In 2022, the Legislature passed Act 12, Session Laws of Hawai‘i, which noted the Office of the Auditor’s biennial reports have repeatedly demonstrated DOH’s failure to develop and implement procedures to verify the accuracy and completeness of data reported by beverage distributors and redemption centers. Act 12 requires DOH to develop a risk-based process to address the issues and concerns that we have repeatedly reported.

Review of Prior Audits

The Office of the Auditor conducted its first audit of the Program in 2005, finding that DOH’s passive oversight of the Program did not ensure a full accounting of its financial transactions or safeguard its assets. Six subsequent audits issued between 2008 and 2018 found that the initial findings and recommendations made in 2005 had not been addressed and remained relevant. For instance, we have consistently reported that DOH’s oversight relies on self-reported numbers from beverage distributors, who must report the number of containers sold and the deposits collected, and from redemption centers, which DOH reimburses based on their reporting of refunds paid to consumers who redeem their deposits. Earlier audits raised concerns that DOH did not verify those numbers, exposing the Program to possible fraud, risk, and abuse. And, in 2018, auditors identified two instances of actual fraud, which DOH reported to the Department of the Attorney General but did not otherwise address.

Instead of continuing to report the same unactioned findings, we took a new approach in 2021, examining *why* DOH failed to take meaningful action to address these chronic issues. In that follow-up effort, DOH attributed its inaction to understaffing; however, we also noted a belief among DOH management that the department should not be responsible for administering the Program, despite being statutorily required to do so. We found that DOH had not taken any significant steps to shore up its Program at that time, although auditors were provided a memorandum from the Solid Waste Coordinator describing a “compliance testing pilot project” that started in July 2020. However, our review of the pilot project found the proposed compliance testing would not adequately address our longstanding findings – and certainly not in a timely manner.

For instance, the pilot program would continue to rely solely on self-reported numbers from distributors and redemption centers. We were also told that due to staffing, the Program could review the transactions of one redemption center each quarter. At the time, there were 62 redemption centers in Hawai'i; we estimated it would take more than 15 years to test compliance at every redemption center in the state.

In 2022, we again switched our approach for the management audit of the Deposit Beverage Container Program, acknowledging that, based on its representations, DOH was in the process of implementing changes to address the audit recommendations in Report No. 21-13, which was issued in December 2021, and the requirements of Act 12. Given the short amount of time since the last audit and potential challenges due to the COVID-19 pandemic, this report summarizes the status of ongoing corrective actions as provided by the department in August 2022.

Mandate

Section 342G-107, HRS, requires the Auditor to conduct a management and financial audit of the Program in even-numbered fiscal years, after the initial audit for the fiscal year ended June 30, 2005. This is our ninth review of the Program. We contracted the certified public accounting firm of KMH LLP to assist us in conducting this financial and program audit.

Audit Objective

1. To determine actions the Program has taken to implement recommendations included in Report No. 21-13 as required by Act 12, Session Laws of Hawai'i 2022.

Audit Scope and Methodology

Given the short amount of time between the issuance of Report No. 21-13 and this one, we determined that it would be unrealistic to expect DOH to have implemented recommendations or to have made significant changes to the administration of the Program. As a result, we changed the approach for the 2022 review. The Office of the Auditor contracted KMH LLP, a certified public accounting firm, to conduct this financial and program audit for the year ended June 30, 2022. We requested that the Program report the status of its implementation of our recommendations, and we summarize its self-reported implementation status in the report below.

What We Reported in 2021

The most recently completed financial and management audit of the Program, Report No. 21-13, was issued in December 2021. In prior reports, we had sampled a small number of records maintained by both distributors and redemption centers. That work is the Program's responsibility, not the job of the Auditor. However, because DOH was not actively involved in managing the Program, there was nothing for us to audit with respect to the Program's performance or management of the Program. The approach for that report was modified to assess *why* there have been no significant changes to the Program despite the same types of findings and recommendations being repeated in prior reviews. Instead of testing distributors and redemption centers' compliance (again, it is the responsibility of management, not an external auditor, to develop processes to ensure compliance) and arriving at the same conclusion as prior audits, the review was modified to consist primarily of a series of interviews with DOH and Program management. Report No. 21-13 contained operational recommendations similar to those in the seven prior financial and program audits. It also included management recommendations to establish objectives, internal controls, policies and procedures, and an action plan for implementation of other recommendations. The 2021 recommendations are attached as Appendix A.

2023 Status Update Provided by Program

The Program provided a status update on its implementation of the most recent audit recommendations in August 2022, which included excerpts from corrective action plans that were part of the Department of Health Corrective Action Plan Updates for Findings and Recommendations for the State for fiscal year ended June 30, 2021. The Program provided additional status updates on actions taken as of August 26, 2022. The ongoing corrective actions related to the Program are summarized below.

Ongoing Corrective Actions

Staffing

In August 2022, DOH's Office of Solid Waste Management, which oversees the Program, reported that it was actively recruiting its fourth inspector since February 2021, as well as filling other vacancies. According to the Program, filling the vacant inspector positions is key to meeting the audit recommendations: "A fully staffed enforcement section will perform significantly more inspections at redemption centers, expeditiously resolve complaints, and conduct enforcement actions on redemption centers and distributors."

Inventory Inspections

In July 2021, the Office of Solid Waste Management increased the frequency of its inventory inspections to document and track the type and volume of beverage containers collected and stored at redemption centers. The office initially reported that inspections would be performed at every redemption center on a quarterly basis; however, additional staffing allowed the Program to further increase the frequency to every other month. Inspectors document the bales of redeemed deposit beverage containers and corresponding estimated weights, which the office's accountants use to verify the reasonableness, generally, of the redemption centers' reports. After the beverage containers have been shipped out of state or sent to permitted recycling facilities, the accountants can reconcile redemption center reports with documented weight tickets from independent end users to provide some level of assurance about accuracy in reporting. According to the Program, significant variations between the redemption reports and independently documented shipping weights will be forwarded to enforcement staff for investigation and corrective action.

Redemption Center Certification

The Office of Solid Waste Management revised its redemption center certification application for new applicants and those renewing certification. The new application, dated September 2021, requires applicants to provide an operational plan that incorporates fraud prevention procedures to ensure that the collected beverage containers are secured and that all receipts given to customers for redeeming deposits correlate with the deposit containers collected. The Office of Solid Waste Management inspectors are responsible for enforcing the requirement that fraud prevention plans are submitted, actionable, and implemented by redemption centers.

Distributor Report Analysis

Act 12, Session Laws of Hawai'i 2022, requires DOH's Office of Solid Waste Management to adopt recommendations from the 2018 audit report and requires beverage distributors to conduct independent third-party audits to verify that their reports and payments to the State are accurate. This will require amendments to the administrative rules for deposit beverage container recycling (Chapter 282, Title 11, Hawai'i Administrative Rules). To assist in updating the State Integrated Solid Waste Management Plan, the Office of Solid Waste Management anticipated convening an advisory committee in November 2022. The advisory committee's responsibilities would include developing any new administrative rules related to the Program.

Modernizing Data Management and Reporting Systems

The Office of Solid Waste Management began implementing a multi-year/multi-phase project with the DOH Environmental Management Division's software developer in January 2021. The first phase, which finished at the end of 2021, included development of a foundational "warehouse" to store and interface with all Program data. The second phase will include a mobile application for use by state and county inspectors in the field. According to the department, this phase was delayed until late-2022 because the software vendor was redirected to develop a sampling interface for DOH following the fuel leak at the U.S. Navy's Red Hill Bulk Fuel Storage Facility.

Future phases would add an online portal for distributor reports and payments, followed by digitization of redemption center reporting. The Office of Solid Waste Management currently receives hard copy reports but intends to transition to online submissions to reduce errors, improve data management, and free up staff to analyze reported inconsistencies.

Conclusion

We appreciate the status updates provided by the Office of Solid Waste Management about its progress in implementing longstanding audit findings to improve the Deposit Beverage Container Program operations and reduce the risk of fraud. We look forward to assessing these efforts in our next review.

Financial Statement Audit



A Hawaii Limited Liability Partnership

Independent Auditor's Report

To the Auditor
State of Hawai'i

Opinion

We have audited the accompanying financial statements of the State of Hawai'i, Deposit Beverage Container Special Fund (the Fund), which comprise the balance sheet – governmental fund as of June 30, 2022, and the related statements of revenues, expenditures, and change in fund balance – governmental fund and budgetary comparison for the fiscal year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Fund as of June 30, 2022, and the change in its financial position and the budgetary comparison thereof for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the Fund and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matter

As discussed in Note A, the financial statements of the Fund, are intended to present the financial position and the changes in financial position of only that portion of the governmental fund type of the State of Hawai'i or the State of Hawai'i, Department of Health that are attributable to the transactions of the Fund. They do not purport to, and do not, present fairly the respective financial position of the State of Hawai'i or the State of Hawai'i, Department of Health as of June 30, 2022, and the changes in its financial position for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Fund's ability to continue as a going concern within one year after the date that the financial statements are issued or available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS and *Government Auditing Standards* will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS and *Government Auditing Standards*, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the Fund's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.

Other Matters

Required Supplementary Information

Management has omitted the management’s discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context. Our opinion on the basic financial statements are not affected by this missing information.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 15, 2023 on our consideration of the Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Fund’s internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Fund’s internal control over financial reporting and compliance.

KMH LLP

KMH LLP

Honolulu, Hawai‘i
June 15, 2023

**Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
Balance Sheet - Governmental Fund
June 30, 2022**

Assets

Equity in Cash and Cash Equivalents and Investments in State Treasury	\$ 57,158,770
Accounts Receivable, Net of Allowance for Doubtful Accounts of \$2,060,625	5,947,922
Accrued Interest Receivable	44,086
	<u>44,086</u>
Total assets	<u>\$ 63,150,778</u>

Liabilities and Fund Balance

Liabilities:	
Vouchers and contracts payable	\$ 4,062,899
Accrued wages and employee benefits payable	44,777
Unearned revenue	10,743
Beverage container deposits	1,953,582
	<u>1,953,582</u>
Total liabilities	6,072,001
Fund Balance--	
Committed to Deposit Beverage Container Program	57,078,777
	<u>57,078,777</u>
Total liabilities and fund balance	<u>\$ 63,150,778</u>

See accompanying notes to the financial statements.

**Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
Statement of Revenues, Expenditures and
Change in Fund Balance - Governmental Fund
For the Fiscal Year Ended June 30, 2022**

Revenues:	
Deposit beverage container fees	\$ 10,206,948
Unredeemed deposits	22,521,061
Investment income	237,437
Nonimposed employee fringe benefits	<u>7,490</u>
Total revenues	<u>32,972,936</u>
Expenditures:	
Handling and redemption fees	26,145,042
Operating expenditures	1,543,145
Administrative expenditures	<u>26,361</u>
Total expenditures	<u>27,714,548</u>
Change in fund balance	5,258,388
Fund Balance at July 1, 2021	<u>51,820,389</u>
Fund Balance at June 30, 2022	<u><u>\$ 57,078,777</u></u>

See accompanying notes to the financial statements.

**Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund
Budgetary Comparison Statement
For the Fiscal Year Ended June 30, 2022**

	<u>Budgeted Amounts</u>		<u>Actual on Budgetary Basis</u>	<u>Variance Favorable (Unfavorable)</u>
	<u>Original</u>	<u>Final</u>		
Revenues--				
Deposit Beverage Container Deposit	\$ 71,138,955	\$ 71,138,955	\$ 62,925,771	\$ (8,213,184)
Expenditures--				
Environmental Health Administration	<u>71,138,955</u>	<u>71,138,955</u>	<u>67,563,005</u>	<u>3,575,950</u>
Deficiency of revenues under expenditures	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (4,637,234)</u>	<u>\$ (4,637,234)</u>

See accompanying notes to the financial statements.

**Department of Health
State of Hawai'i
Deposit Beverage Container Deposit Special Fund**

**Notes to Financial Statements
June 30, 2022**

NOTE A - ESTABLISHMENT AND PURPOSE OF THE FUND

In 2002, the State of Hawai'i Legislature passed Act 176 to establish the Deposit Beverage Container Deposit Program and the Deposit Beverage Container Deposit Special Fund (DBC Fund). The purpose of Act 176 was to increase participation in deposit programs, increase recycling rates for specified deposit beverage containers, provide a connection between manufacturing decisions and recycling program management, and reduce litter.

Pursuant to Section 342G, Part VIII of the Hawai'i Revised Statutes (HRS), the DBC Fund was initiated on July 1, 2005, to implement a Deposit Beverage Container Program, establish minimum standards for the collection of empty beverage containers, to foster systems of redemption which facilitate recycling of empty beverage containers, and to minimize costs without inconveniencing customers. Under the DBC Fund, the State of Hawai'i (the State) collects from manufacturers and distributors, a \$0.05 per container refundable deposit on eligible beverage containers manufactured in or imported to the State that are expected to be sold in the State. The deposits are used to reimburse redemption centers. In addition, the DBC Fund assessed a per container handling fee of \$0.015 per container until August 31, 2015. Effective September 1, 2015, the handling fee was lowered to \$0.01 per container.

The DBC Fund is administered by employees of the Solid Waste Branch, Environmental Management Division of the State of Hawai'i, Department of Health (the Department).

The accompanying financial statements are intended to present the financial position and the changes in financial position of only that portion of the governmental fund type of the State and the Department that are attributable to the transactions of the DBC Fund. They do not purport to, and do not, present fairly the financial position of the State or the Department as of June 30, 2022, and the changes in its financial position for the fiscal year then ended in accordance with accounting principles generally accepted in the United States of America.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

1. Basis of Presentation

The financial statements of the DBC Fund are reported using the current financial resources measurement focus and modified accrual basis of accounting. Revenues are recognized as soon as they are both measurable and available. Revenues are considered available when they are collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the DBC Fund considers revenues to be available if they are collected within 60 days after the end of the current fiscal year. Revenues susceptible to accrual include a container fee of \$0.01 per beverage container sold. In

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NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

In addition, the amounts for deposits of \$0.05 are deferred when collected, and the amount estimated to be forfeited is recognized as revenue at the end of the fiscal year.

Expenditures are generally recorded when a liability is incurred; however, expenditures related to compensated absences are recorded only when payment is due.

Encumbrances are recorded for obligations in the form of purchase orders or contracts at the time purchase orders or contracts are awarded and executed. Encumbrances outstanding at fiscal year-end are reported as reservations of fund balance since they do not constitute expenditures or liabilities.

Had the financial statements been presented on the full accrual basis of accounting, additional adjustments would need to be recorded. These adjustments are recorded on a department-wide level for all governmental activities of the Department. The DBC Fund's portion of these department-wide accruals includes adjustments for capital assets and accrued vacation. At June 30, 2022, the DBC Fund's portion of these accruals was as follows:

Total fund balance on the modified-accrual basis of accounting	\$ 57,078,777
Capital assets used in governmental activities are not financial resources and therefore are not reported as an asset in the governmental funds	6,005
Compensated absences reported in the statement of net position do not require the use of current financial resources and are not reported as liabilities in the governmental funds	(150,456)
Other financing sources not collected within 60 days and therefore not available for current financial resources as reported as unavailable revenues in the governmental funds	<u>10,743</u>
Total net assets on the full accrual basis of accounting	<u><u>\$ 56,934,326</u></u>

At June 30, 2022, the DBC Fund's portion of the department-wide activities is not materially different from the DBC Fund's activity.

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NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

2. Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America (U.S. GAAP), management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenditures during the reporting period. Actual results could differ from those estimates.

3. Governmental Funds - Fund Balance

The DBC Fund accounts for governmental fund balances in accordance with Governmental Accounting Standards Board (GASB) Statement No. 54 (GASBS 54), *Fund Balance Reporting and Governmental Fund Type Definitions*. GASBS 54's hierarchical fund balance classification structure is based primarily on the extent to which a government is bound to follow constraints on how resources can be spent. Classifications include:

- *Nonspendable fund balance* - amounts that are not in spendable form (such as inventory) or are required to be maintained intact;
- *Restricted* - amounts constrained to specific purposes by their providers (such as creditors, grantors or other governments) through constitutional provisions, or by enabling legislation;
- *Committed* - amounts constrained to specific purposes by a government itself, using its highest level of decision-making authority; to be reported as committed, amounts cannot be used for any other purpose unless the government takes the same highest level of action to remove or change the constraint;
- *Assigned* - amounts a government intends to use for a specific purpose; intent can be expressed by the governing body or by an official or body to which the government delegates the authority; and
- *Unassigned* - amounts that are available for any purpose; positive amounts are reported only in the general fund.

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NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

When both restricted and unrestricted balances are available for use, it is the DBC Fund's policy to use restricted fund balance first, then unrestricted fund balance. Furthermore, committed fund balances are reduced first, followed by assigned amounts, and then unassigned amounts when expenditures are incurred for purposes for which amounts in any of those unrestricted classifications can be used.

4. Equity in Cash and Cash Equivalents and Investments in State Treasury

All monies of the DBC Fund are held in the State Treasury. The State Director of Finance is responsible for the safekeeping of cash in the State Treasury in accordance with State laws. The Director of Finance may invest any monies of the State, which in the Director's judgment, are in excess of the amounts necessary for meeting the immediate requirements of the State. Cash is pooled with funds from other State agencies and departments and deposited into approved financial institutions or in the State Treasury Investment Pool System. Funds in the investment pool accrue interest based on the average weighted cash balances of each account.

At June 30, 2022, information relating to the types, insurance, collateral, and related interest rate, credit and custodial risks of funds deposited with the State Treasury was not available for the DBC Fund since such information is determined on a statewide basis. Cash deposits with the State Treasury are either federally insured or collateralized with obligations of the State or United States of America. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

5. Accounts Receivable

Revenue is earned when it is considered measurable and available. The accounts receivable balance represents the expected receipts from distributors based on deliveries of the containers as of June 30, 2022, net of any allowance for uncollectible accounts. At June 30, 2022, allowance for uncollectible accounts amounted to \$2,060,625.

6. Beverage Container Deposits and Container Fees

Deposits of \$0.05 are made by distributors to the DBC Fund for each qualifying container sold. The DBC Fund maintains all deposits until the recycling centers claim reimbursement for the deposits that they pay out to the consumers. The DBC Fund maintains the deposits that are expected to be redeemed. In addition, deposits of \$0.01 are made by the distributors to the DBC Fund for each qualifying container as a container fee.

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**Notes to Financial Statements
June 30, 2022**

NOTE B - SIGNIFICANT ACCOUNTING POLICIES (Continued)

Amounts paid out to the consumers are based on containers redeemed or a predetermined weight per type of container redeemed (i.e. aluminum, mixed plastics, etc.). These weights are determined based on the mix of containers redeemed and are reviewed when necessary. Management adjusts the deposit liability balance and unredeemed deposit revenue recognized based on the amount of deposits refunded in the first three months of the subsequent fiscal year related to deposits collected prior to year end. Deposits not refunded within the first three months of the subsequent fiscal year are recognized as revenue for the previous year and recorded as unredeemed deposits in the accompanying statement of revenues, expenditures and change in fund balance.

7. Administrative Costs

The accompanying financial statements do not reflect certain administrative costs, which are paid for by other sources of funding from the Department. These costs include the Department's and State's overhead costs which the Department does not assess to the DBC Fund, since they are not practical to determine.

NOTE C - BUDGETING AND BUDGETARY CONTROL

The DBC Fund follows these procedures in establishing the budgetary data reflected in the basic financial statements:

The Budget

Not less than 20 days before the State Legislature convenes in every odd-numbered year, the Governor submits to the State Legislature, and to each member thereof, a budget which contains the program and budget recommendation of the Governor for the succeeding biennium. The budget in general contains: the State program structure; statements of statewide objectives; financial requirements for the next biennium to carry out the recommended programs; a summary of State receipts and revenues in the last completed fiscal year; a revised estimate for the fiscal year in progress; and an estimate for the succeeding biennium.

Legislative Review

The State Legislature considers the Governor's proposed program and financial plan and budget, evaluates alternatives to the Governor's recommendations, adopts programs, and determines the State budget. It may, from time to time, request the Department of Budget and Finance and any agency to conduct such analysis of programs and finances and will assist in determining the State's program and financial plan and budget.

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June 30, 2022**

NOTE C - BUDGETING AND BUDGETARY CONTROL (Continued)

Program Execution

Except as limited by policy decisions of the Governor, appropriations by the State Legislature, and other provisions of law, the agencies responsible for the programs administer the Programs and are responsible for their proper management. The appropriations by the State Legislature for a biennium are allocated between the two fiscal years of the biennium in the manner provided in the budget or appropriations act and as further prescribed by the Director of Finance. No appropriation transfers or changes between programs or agencies can be made without legislative authorization. Authorized transfers or changes, when made, should be reported to the State Legislature.

Budgetary control is maintained at the appropriation line item level established in the appropriation acts.

A budget is adopted for the DBC Fund and is prepared on the cash basis of accounting, which is a basis of accounting other than U.S. GAAP.

The major differences between the budgetary and U.S. GAAP bases are that: (1) the budget is prepared on the cash basis of accounting; (2) encumbrances are recorded as the equivalent of expenditures under the budgetary basis; and (3) collections and payments of certain refundable deposits are not recognized as revenues and expenditures under U.S. GAAP.

Since budgetary basis differs from U.S. GAAP, budget and actual amounts in the budgetary comparison statements are presented on the budgetary basis. A reconciliation of excess of expenditures over revenues on a budgetary basis for 2022, to the change in fund balance presented in conformity with U.S. GAAP follows:

Deficiency of revenues under expenditures - actual on a budgetary basis	\$ (4,637,234)
Current year's appropriations encumbered at June 30, 2022	28,057,622
Expenditures for liquidation of prior fiscal year encumbrances	(21,775,180)
Accruals and other adjustments	<u>3,613,180</u>
Change in fund balance - U.S. GAAP basis	<u><u>\$ 5,258,388</u></u>

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**Notes to Financial Statements
June 30, 2022**

NOTE D - BEVERAGE CONTAINER DEPOSITS

The changes to the beverage container deposits liability during fiscal year 2022 were as follows:

Balance as of July 1, 2021	\$ 4,115,173
Increase: Deposits Received from distributors	51,513,837
Decrease: Payments made to recycling centers, net of refunds	(31,154,367)
Decrease: Unredeemed deposits recognized as revenue	<u>(22,521,061)</u>
Balance as of June 30, 2022	<u>\$ 1,953,582</u>

NOTE E - EMPLOYEE BENEFIT PLANS

Substantially all eligible employees of the DBC Fund participate in the State's retirement and other post-employment benefit plans. The State's plans include the Employee's Retirement System (ERS) of the State, the Hawaii Employer-Union Health Benefits Trust Fund (EUTF), a deferred compensation plan, and sick leave benefits. For information on the State's benefit plans, refer to the State of Hawai'i, ERS's, and EUTF's Annual Comprehensive Financial Reports (ACFR), or the audited financial statements of the Department. The State's ACFR can be found at the DAGS website: <http://ags.hawaii.gov/reports/financial-reports/>. The ERS ACFR can be found at the ERS website: <http://ers.ehawaii.gov/resources/financials/>. The EUTF ACFR can be found at the EUTF website: <http://eutf.hawaii.gov/reports/>. The actuarial valuations of the ERS and EUTF does not provide retirement and other post-employment benefit, respectively, information by department or agency. Accordingly, the State's policy on the accounting and reporting for retirement and OPEB is to allocate a portion of the State's Annual Required Contribution (ARC), interest, and any adjustment to the ARC, to component units and proprietary funds that are reported separately in the stand-alone department financial statements or in the State's ACFR.

**Department of Health
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**Notes to Financial Statements
June 30, 2022**

NOTE F - COMMITMENTS AND CONTINGENCIES

The State maintains certain insurance coverage to satisfy bond indenture agreements as well as for other purposes, but is substantially self-insured for all other perils including workers' compensation. The State records a liability for risk financing and insurance related losses, including those incurred but not reported, if it is determined that a loss has been incurred and the amount can be reasonably estimated. The State retains various risks and insures certain excess layers with commercial insurance companies. At June 30, 2022, the State recorded estimated losses for workers' compensation, automobile, and general liability claims as long-term liabilities as the losses will not be liquidated with currently expendable available financial resources. The estimated losses will be paid from legislative appropriations of the State's General Fund. The DBC Fund did not have a portion of the State's workers' compensation expense for the fiscal year ended June 30, 2022.



Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Independent Auditor's Report

To the Auditor
State of Hawai'i

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the State of Hawai'i, Deposit Beverage Container Deposit Special Fund (the Fund), which comprise the balance sheet – governmental fund as of June 30, 2022, and the related statements of revenues, expenditures and change in fund balance – governmental fund, budgetary comparison for the fiscal year then ended, and the related notes to the financial statements, and have issued our report thereon dated June 15, 2023.

Report on Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Fund's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control. Accordingly, we do not express an opinion on the effectiveness of the Fund's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify a deficiency in internal control, described below, that we consider to be a significant deficiency:

Reliance on Third Party Certifications

The Deposit Beverage Container Program (Program) receives beverage container deposits and container fees from distributors and refunds deposits and pays handling fees to redemption centers based on certified information. The Program relies on certifications from distributors to support deposits and container fees received. The Program also relies on certifications from redemption centers to support deposit refunds and handling fees paid. Overreliance on the self-reporting by distributors and redemption centers may result in underpayments on deposits and the related container fees received by the Department to administer the program, overpayments of deposit refunds and handling fees to redemption centers, and an overstated redemption rate. An overstated redemption rate could result in a misstatement in the Department's financial statements, as well as higher container fees for consumers to support the program.

Report on Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Fund's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the financial statements. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Fund Management's Response to Findings

The Fund management's responses to the findings identified in our audit are described in the attached response. The Fund management's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KMH LLP

KMH LLP

Honolulu, Hawai'i
June 15, 2023

Office of the Auditor's Comments on the Department of Health's Response to the Audit Findings

WE TRANSMITTED a draft of this report to DOH on June 9, 2023, and met with the Deputy Director of Environmental Health, Solid and Hazardous Waste Branch Chief, and Solid Waste Coordinator to discuss our audit findings on June 14, 2023. DOH subsequently informed us that it would not be submitting a written response to the draft report.

APPENDIX A

The following recommendations were provided to the Department of Health's Deposit Beverage Container Program in Report No. 21-13, issued in December 2021. We will conduct a thorough assessment of the Program's efforts to implement these recommendations in our next follow-up review.

What we recommended in 2021:

1. DOH management should establish clear, measurable objectives for the Program. Those objectives should state what is to be achieved by Program management and set timelines for completion. The objectives should include a detailed action plan as well as policies and procedures to address the audit findings reported in prior audit reports, including Report Nos. 19-08, 17-02, and 15-02. DOH management should update and revise the objectives as appropriate.
2. DOH management should establish internal controls, including policies and procedures, to ensure that Program management is addressing the issues reported in prior audit reports and managing the Program appropriately. Those internal controls should be designed to provide DOH management with reasonable assurance that the Program is achieving its statutory purpose and administered effectively and efficiently as well as meeting any objectives established by DOH management.
3. Program management should develop an action plan that details the specific measures that address the findings reported in Report Nos. 19-08, 17-02, and 15-02 and identifies additional resources that may be required. The action plan should also feature a corresponding timeline for implementation of the identified measures, including dates of deliverables and milestones. At a minimum, the action plan should include:
 - a. A process to select distributor and redemption center reports submitted to the Program to audit on a periodic basis. That process should be risk-based and the Program should consider factors such as the number of transactions, prior findings reported in our audit reports as well as by distributor and redemption center's independent financial auditors, and the frequency of the distributor or redemption center's financial audits. Program management should retain an independent auditing organization, as authorized under 342G-104(b)(1), HRS, to perform the audits if the Program does not have sufficient staff or expertise to perform that work.
 - b. A requirement for distributors to periodically submit records that support the information contained in the Monthly Distribution Report Form, such as schedule invoices, shipping documents, and point-of-sale records. The records may allow the Program to identify differences in the Monthly Distribution Report Forms.
 - c. A process to consider and initiate administrative enforcement actions, as appropriate.

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4. Program management should require certain distributors to develop and submit to the Program for approval an internal control process to provide reasonable assurance that the information self-reported on the Monthly Distribution Report Form is accurate and that the distributor maintains sufficient and appropriate records to support the reported information. Program management should amend the Program's administrative rules, if necessary.
 5. Program management should develop policies and procedures to direct and guide staff in their respective Program responsibilities. The policies and procedures should be documented and updated, as necessary.
 6. Program management should retain the services of a third party to administer the Program, as authorized under 342G-106, HRS, if the Program does not have sufficient staff or expertise to actively oversee its activities and implement the audit recommendations.
 7. For each redemption center, Program management should annually reconcile the weight of the materials redeemed (for which the Program reimbursed the container deposit and paid the handling fee) with the weight ticket or tickets for each material type generated by the certified recycling facility. While we recognize that the materials redeemed may not be the same materials received by the recycling facility during the period, Program management should consider whether it can reasonably account for such differences. The purpose of reconciling the weights is to provide a certain level of assurance about the accuracy of the number of containers the redemption center has claimed to have redeemed and for which it has been reimbursed by the Program.
 8. Program management should develop an electronic reporting system that requires distributors and redemption centers to input information directly into a centralized database. In addition to eliminating handwritten logs and other manual, duplicative processes, an electronic reporting system may allow the Program to automate certain processes.